

D. IRC 501(k) - CHILD CARE ORGANIZATIONS

1. Introduction

This topic will discuss a provision of the Internal Revenue Code, IRC 501(k), that was added by the Deficit Reduction Act of 1984. The legislative history of the provision and the Service position on child care organizations will be reviewed. The current status of efforts to provide further guidance in administering the provision will also be described.

2. Exemption For Child Care Organizations Prior to IRC 501(k)

Prior to the enactment IRC of 501(k), the Service position was that nonprofit day care centers could be recognized as exempt under IRC 501(c)(3) in only two situations: 1) where enrollment was limited to children from low income families, or 2) where the center provided preschool children with a comprehensive educational program through a professional staff of qualified teachers, in essence, where the center was a school.

The Service's earliest position on day care centers was O.D. 340, published in 1919 in C.B. 202, which provided that an organization, incorporated for the purpose of establishing and maintaining a day nursery for young children whose parents were obliged to work and had no means to provide care for their children during the day, and which derived its income from subscriptions and donations and a small amount from securities, all of which was used in promoting the activities of the nursery, was exempt from taxation under section 231(6) of the Revenue Act of 1918, a predecessor of IRC 501(c)(3).

Rev. Rul. 68-166, 1968-1 C.B. 255, updated and restated the earlier ruling of O.D. 340. The revenue ruling provides that a nonprofit organization formed to operate a day care center for young children of needy working parents, who have no means to provide care for their children during the day, qualifies for exemption under IRC 501(c)(3). The organization charged a nominal fee and was largely dependent on contributions for support.

Rev. Rul. 70-533, 1970-2 C.B. 112, provides that an educational day care center, operated in conjunction with an industrial company, that enrolls children on the basis of family financial need and the child's need for the care and development program of the center qualifies for exemption under IRC 501(c)(3). The revenue

ruling does not discuss foundation classification status. It does, however, note that the organization provided educational activities and maintained a professional staff of qualified teachers experienced in the education of pre-school age children. The revenue ruling notes that "[b]y providing pre-school age children of working parents with an educational program ... and by providing care for the children, the organization is advancing education." The center was found to be charitable within the meaning of Reg. 1.501(c)(3)-1(d)(2) in that it operated for the "relief of the poor and distressed or of the underprivileged and the advancement of education." Our records indicate that the organization received a foundation classification status under IRC 509(a)(1) and IRC 170(b)(1)(A)(vi).

Rev. Rul. 73-430, 1973-2 C.B. 362, considered whether a day care center operated as an activity of a community development corporation exempt from federal income tax as an organization described in IRC 501(c)(3) qualified as a "nonprofit educational organization" for purposes of the exemption from the retailers, manufacturers, and communication taxes. For purposes of exemption from such taxes, a "nonprofit educational organization" means an educational organization described in IRC 170(b)(1)(A)(ii) that is exempt from income tax under IRC 501(a). The center was a state licensed educational center that maintained a teaching staff including graduate and undergraduate students specializing in early childhood education. Daily planned subjects included the alphabet, elementary numbers, art, basic science and nature studies, musical games, and puzzle solving. The center was also treated as a private school for purposes of the racial nondiscrimination requirement of Rev. Rul. 71-447, 1971-2 C.B. 230.

The preceding revenue rulings set forth the two options under which child care organizations qualified for recognition of federal income tax exemption before IRC 501(k). The parameters of the options were the subject of two Tax Court decisions in 1978. In both San Francisco Infant School, Inc. v. Commissioner, 69 T.C. 957 (1978), and Michigan Early Childhood Center, Inc. v. Commissioner, T.C.M. 1978-186, the Tax Court found that the subject organizations were not providing custodial child care but rather were educational in that they had a curriculum and trained teachers. The Service acquiesced in San Francisco Infant School, Inc. 1978-2 C.B. 2.

Based on these cases, the Service accepted a very liberal view of what constitutes "education" in the context of day care. The reasoning of these court cases was further extrapolated to support expansive interpretations of what constitutes a "curriculum" under Reg. 1.170A-9(b)(1) for purposes of foundation

classification under IRC 170(b)(1)(A)(ii). As a result, organizations that operated a day care center as their primary activity and were found to qualify for exemption under IRC 501(c)(3) as "educational" have uniformly been classified as schools under IRC 170(b)(1)(A)(ii). Theoretically, however, an organization providing only custodial child care not limited to children from low income families would not have qualified for recognition of exemption prior to IRC 501(k).

3. Statute and Legislative History

IRC 501(k) provides that the term "educational purposes," as used for purposes of IRC 501(c)(3), includes the providing of care for children away from their homes if 1) substantially all of the care provided by the organization is for purposes of enabling individuals to be gainfully employed, and 2) the services provided by the organization are available to the general public. Thus, in a manner similar to IRC 501(e), 501(f), and 501(j), IRC 501(k) adds a specific definition to the broad terms of IRC 501(c)(3). IRC 501(k) is effective for tax years beginning after July 18, 1984.

The legislative history of IRC 501(k) is sparse. Questions such as the issue of foundation classification status are not specifically addressed in any of the conference or committee reports. H.R. Rep. No. 98-432 (Part 2), 98th Cong., 2d Sess. (1984), Supplemental Report of the House Ways and Means Committee, states:

The committee understands that definitional difficulties have arisen with respect to whether certain non-profit day care centers which provide after-school care to children or care for infants or toddlers meet the present law requirements for tax-exempt status and eligibility for tax-deductible contributions as educational or charitable organizations. Accordingly, the committee believes that certain nonprofit day care centers which make their services available to the general public should so qualify.

H.R. Rep. No. 98-861, 98th Cong., 2d Sess. (1984), 1984-3 C.B. 1100, Vol. 2, Conference Report, indicates that IRC 501(k) is not intended to affect the meaning of the terms "educational" or "charitable" for any purpose other than considering the child care organizations described in the provision as having educational purposes.

The Senate Committee on Finance Report states that "[t]he committee believes that certain nonprofit day care organizations which make their services available to the general public should be considered to have educational purposes without regard to the present law interpretation of that term as applied to such day care organizations." S. Rep. No. 98-169, 98th Cong., 2d Sess. (1984).

As noted, the legislative history of IRC 501(k) does not address the issues of foundation classification and does not provide much insight into the legislative intent. The House Ways and Means Committee Report does, however, indicate that an awareness existed as to the "definitional difficulties" in classifying day care organizations as educational or charitable. It can be argued that IRC 501(k) was designed to remove the Service from involvement in definitional and interpretational issues relating to exemption for day care organizations which now automatically qualify under 501(c)(3) by virtue of IRC 501(k).

Furthermore, the Senate Committee on Finance Report states that IRC 501(k) organizations should be considered to have educational purposes "without regard to present-law interpretations of that term as applied to such day care organizations." This statement supports an argument that organizations described in IRC 501(k) need not first be analyzed under traditional concepts of "charity" or "education."

4. Additional Guidance

The National Office is currently considering a number of questions relating to IRC 501(k) organizations, including the issue of private foundation classification. Chief Counsel, Employee Plans and Exempt Organizations, is drafting regulations under that section as well.

Day care centers that do not clearly qualify as educational or charitable may be considered under IRC 501(k). However, in accordance with the general rules of Rev. Proc. 84-46, 1984-1 C.B. 541, such cases should be referred to the National Office because of the lack of published guidance. Day care centers described in IRC 501(k) are considered "educational" only for purposes of determining recognition of exemption status under IRC 501(c)(3). A finding that a day care center is described in IRC 501(k) and thus qualified under IRC 501(c)(3) is not determinative of its foundation classification status.

As stated previously, the IRC 501(c)(3) "educational" regulations at Reg. 1.501(c)(3)-1(d)(3) are broader in scope than the definition of a school contained in

IRC 170(b)(1)(A)(ii) and Reg. 1.170A-9(b). A finding that an organization is "educational" within the meaning of IRC 501(c)(3) does not necessitate a finding that the organization is a school within the meaning of IRC 170(b)(1)(A)(ii). The "educational" day care centers described in IRC 501(k) do not automatically qualify for a public charity classification status under IRC 509(a)(1) and 170(b)(1)(A)(ii). In fact, an educational organization described in IRC 170(b)(1)(A)(ii) would qualify for recognition of exemption under IRC 501(c)(3) without reference to IRC 501(k).